Southeastern Bankruptcy Law Institute

Thirieth Annual Seminar on Bankruptcy Law and Rules

Chapter 11 First Day Orders

Brad Eric Scheler
Fried Frank Harris Shriver & Jacobson LLP
© Copyright 2004

I. General Background

A. On the first day of a chapter 11 case "first-day motions" are typically filed by the Debtor to assist in case stabilization. Debtors typically argue that only through entry of orders approving of these first day motions, can they stabilize their work force, maintain critical relations with the vendor community, and take steps to ensure that their cash management systems and operations in general are as normalized as possible.[1]

B. The hearing on first day motions are the debtor's unique opportunity to have unfettered access to the bankruptcy court, before a creditors' committee has had a chance to be formed, to lay an organized and prepared foundation before the court and set the tone for the rest of the bankruptcy case.

C. Debtors have also taken this opportunity to seek relief that is generally based solely on the debtor's business judgment, such as the rejection of executory contracts and leases, which will encounter little if any opposition especially on the first day of a case.

II. Types of First Day Motions

A. Motion for joint administration of cases

B. Motion to prohibit utilities from altering or refusing services and to establish procedures for determining requests for additional adequate assurance

C. Motion to authorize the company's employee payroll and benefits program

D. Motion to approve the company's cash management system

E. Motion to authorize the payment of certain prepetition taxes

F. Motion to establish reclamation procedures

G. Motion for the use of a company's cash collateral

H. Motion to approve debtor in possession financing

I. Motion for the payment of the prepetition claims of certain critical vendors

---

1 See Steven N. Cousins, et al., The Doctrine of Necessity - Everything Is Critical!, ABI Annual Spring Meeting 2002, available on Westlaw at 041802 ABI-CLE 149.

III. Critical Vendor Motions

A. Rationale

1. Large chapter 11 debtors typically seek court authority on or about the first day of a case to pay a portion or all of the prepetition claims of certain critical trade vendors. The rationale employed is that the debtor relies on certain vendors for critical products and services, and unless the debtor is permitted to pay its prepetition debts to these essential vendors, they likely will stop supplying the debtor, and the debtor's chances of successfully reorganizing will be impaired.[2]

2. The more prevalent use of critical vendor motions in recent bankruptcy cases has grown from the development of prepackaged chapter 11 cases and the borrowed notion that the debtor should be able to preserve the status of its prepetition vendors while it works out the other aspects of its restructuring. This concept is now being challenged in cases such as Capital Factors Inc. v. Kmart Corp. (see Section III.G. below).

B. Authority

1. The authority for paying prepetition claims of certain critical vendors, as an exception to the general rule that a debtor cannot pay prepetition claims, is section 105(a) of the Bankruptcy Code, which provides that "[t]he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code]," and the Doctrine of Necessity as influenced by the Six Months Rule, an equitable rule of priority followed in railroad reorganization cases where railroad receivers were entitled to pay the unpaid claims of operations creditors arising in the six months preceding the reorganization before paying mortgagees and secured creditors, giving these claims a priority status.[3]

---

2 See Andrew J. Currie and Sean McCann, Hold on to Those Payments, Critical Vendors: Capital Factors v. Kmart, Feature, 2003 ABI JNL. LEXIS 100; Bruce H. White and William L. Medford, The Doctrine of Necessity and Critical Trade Vendors: The Impracticality of Maintaining Post-petition Business Relations in Mega-cases, Practice & Procedure, 2002 ABI JNL. LEXIS 137.

3 See id.; Russell A. Eisenberg & Frances F. Gecker, The Doctrine of Necessity and its Parameters, 73 Marq. L. Rev. 1 (1989); *In re* CoServ L.L.C. 273 B.R. 487 (Bankr. N.D. Tex. 2002). The Six Months Rule later became codified in the Bankruptcy Act as § 77(b), and subsequently survived the enactment of the Bankruptcy Code as § 1171(b). However, § 1171(b) applies only to railroad reorganizations, not all chapter 11 reorganizations.

2. In addition to the Six Months Rule, the Necessity of Payment Rule is another railroad reorganization doctrine that has provided a foundation for the contemporary practice of paying critical vendors. Under this rule, a railroad receiver was protected in making payments to certain prepetition creditors whose goods and services were essential to continuing rail service. The Necessity of Payment Rule was justified, in part, because the continued operation of rail lines was essential to protect the public interest.[4]

3. The Doctrine of Necessity was first enunciated by the U.S. Supreme Court in Miltenberger v. Logansport C. & S.W.R. Co.[5] and has been followed by numerous courts both inside and outside the context of railroad reorganizations.[6]

C. Other Similar First Day Motions

1. In addition to critical vendors, courts have approved payments of prepetition unsecured claims when necessary for a successful reorganization,[7] or to at least preserve the potential of a rehabilitation of the debtors' business or prevent a liquidation,[8] in several other similar contexts such as (i) paying prepetition wages, (ii) maintaining customer programs, (iii) paying certain lien creditors, (iv) maintaining insurance programs and (v) paying for post-petition deliveries of goods ordered prepetition by vendors.[9]

D. Types of Relief Requested[10]

1. Many critical vendor motions contain a section identifying the categories or names of specific critical vendors the debtor seeks authority to pay.[11] Some critical vendor motions do not identify

---

4 See Cousins, et al., supra note 1; Patricia L. Barsalou and Zack Mosner, Preferential First-day Orders: Same Question, Different Look, Affairs of State, 2003 ABI JNL. LEXIS 7.

5 106 U.S. 286 (1882).

6 See Barsalou & Mosner, supra note 4. Cf. B & W Enterprises, 713 F.2d 534 (9th Cir. 1983) (declining to extend the doctrine to non-railroad cases) with *In re* Just for Feet Inc., 242 B.R. 821, 826 (D. Del. 1999) (citing *In re* Financial News Network Inc., 134 B.R. 732, 736 (Bankr. S.D.N.Y. 1991) in extending the doctrine to non-railroad debtors).

7 See, e.g., *In re* Wehrenberg, 260 B.R. 468 (Bankr. E.D. Mo. 2001); *In re* Just for Feet Inc., 242 B.R. 821; *In re* Federated Dept. Stores Inc., 121 B.R. 332 (Bankr. S.D. Ohio 1990); *In re* Boston & Maine Corp., 634 F.2d 1359 (1st Cir. 1980).

8 See Bruce S. Nathan, Critical Vendors: Elevating the Low-priority Unsecured Claims of Prepetition Trade Creditors, Last in Line, 2002 ABI JNL. LEXIS 93.

9 See Currie & McCann, supra note 2.

10 See id.

11 Some critical vendor motions describe the implementation of a detailed system to track payments made to critical vendors.

any critical vendors or amounts to be paid, in which case the critical vendor motion will set forth criteria that the debtors will apply to assess whether a vendor is critical. Some of the considerations that debtors list in the motion are whether (i) the goods or services provided can be replaced, (ii) the failure to pay a critical vendor will require the debtor to incur higher costs for goods or services post-petition, (iii) the failure to pay a critical vendor will cause the debtor to lose sales or future revenues and (iv) the failure to pay a critical vendor will cause a delay in supply of critical goods and services.

2. Similarly, many critical vendor motions specify an aggregate maximum amount up to which the debtor can pay prepetition claims to critical vendors. Usually this cap does not constitute the total prepetition amount owed to all critical vendors. A debtor usually seeks authority to pay only the amount necessary for it to continue in business while reserving the right to seek later court authority to increase this amount if the cap proves inadequate.

3. Many critical vendor motions ask the court to enter an order, and occasionally to approve a form agreement to be entered into by the debtor and a critical vendor, which conditions payment upon the vendor abiding by the following guidelines: (i) removal of all liens, (ii) agreement not to initiate new liens and (iii) agreement that it will not require a lump-sum payment upon confirmation of a reorganization plan on account of any administrative expense priority claim it might assert.

E. Expedited Notice

1. As the debtor is compelled by legitimate business concerns to move quickly for the bankruptcy court's authorization of a critical vendors motion, it may raise due process concerns for those parties in interest most likely impacted by the debtor's request, including the creditors' committee which may not have even been formed, as such parties may not have sufficient time to determine the appropriateness of the requested relief or the validity of the threats motivating the action.[12] To avoid these concerns, the trend is for the court to conduct an emergency hearing on limited notice, often on the first day of the case, and then give broader notice to a larger group of interested persons, thus giving all persons an opportunity to be heard. The relief

---

12 See Cousins, et al., supra note 1, at 2 (arguing that as a result of that practice, the debtor's evidence supporting the essential nature of the payments may be weak and go unchallenged, and that as unsecured creditors become more sophisticated and first day orders become more commonplace, the membership of creditors' committees may be less critical or scrutinous of an agenda based upon preferential treatment of the few allegedly 'critical' vendors).

granted at the emergency hearing is typically limited as the circumstances require.[13]

F. Proof Required to Substantiate Relief

1. Some courts have attempted to more clearly delineate the standards required to substantiate the relief requested in critical vendors motions by requiring the debtor to prove, by a preponderance of the evidence, for a creditor to be considered a critical vendor, that: (i) it must be critical that the debtor deal with the claimant; (ii) unless it deals with the claimant, the debtor risks the probability of harm, or alternatively, loss of economic advantage to the estate or the debtor's going-concern value, which is disproportionate to the amount of the claimant's prepetition claim; and (iii) there is no practical or legal alternative by which the debtor can deal with the claimant other than by payment of the claim.[14] Courts that have focused on the last element, suggest that debtors may have several mechanisms at their disposal, besides paying a claimant's prepetition debt, to ensure that a prepetition creditor continues to deal with the debtor postpetition.[15]

G. Capital Factors Inc. v. Kmart Corp. (the "*Kmart* decision")[16]

1. The *Kmart* decision arose from an appeal from four first-day, critical vendor orders of the bankruptcy court issued in late January 2002 in Kmart's chapter 11 reorganization. These orders authorized the debtor to pay, at its discretion, in excess of $320 million to prepetition vendors (both foreign and domestic), liquor distributors, and advertising companies that were all in the estimation of the debtor's management, "critical vendors" without whose goodwill and support Kmart could not effectively reorganize.

2. Capital Factors, a factoring company with an unsecured claim of about $20 million, was not included on Kmart's critical vendors list and objected to Kmart's critical vendor motion. Its objection

---

13 See Eisenberg & Gecker, supra note 4, at 12-13.

14 See *In re* CoServ L.L.C., 273 B.R. 487. See also *In re* Equalnet Communications Corp., 258 B.R. 368 (Bankr. S.D. Tex. 2000); *In re* Tri-Union Dev. Corp., 253 B.R. 808 (Bankr. S.D. Tex. 2000) (acknowledging the prohibition of payment of prepetition claims prior to the confirmation of a plan and articulate narrowly tailored exceptions to prohibition).

15 *In re* CoServ L.L.C., 273 B.R. at 498-99. Among these "alternatives" are a deposit, c.o.d., letters of credit, consignment arrangements and the ability to sue a claimant for violating the automatic stay if a claimant is attempting to coerce payment of prepetition debt by linking such payment to the provisions of credit post-petition. Id. at 499. See also White & Medford, supra note 2.

16 291 B.R. 818 (N.D. Ill 2003).

was denied by the bankruptcy court. Although Capital Factors took an appeal of the bankruptcy court's decision, it did not obtain a stay of the bankruptcy court's first-day orders. Kmart, therefore, paid out approximately $327 million in prepetition vendor claims.

3. In its decision issued on April 8, 2003, the U.S. District Court for the Northern District of Illinois (the "District Court") reversed all four of the bankruptcy court's critical vendor first-day orders and remanded the matter back to the bankruptcy court to order the return of all the money paid to these vendors.[17]

4. Kmart had relied on the Doctrine of Necessity and section 105 of the Bankruptcy Code. Moreover, Kmart asserted that since Capital Factors never obtained a stay of the first-day orders pending appeal, and since hundreds of millions of dollars had been paid to the critical vendors in reliance on the court order, the doctrine of "equitable mootness" precluded the district court from granting relief to Capital Factors.

5. The District Court, however, held that the Doctrine of Necessity does not exist in the current Bankruptcy Code. In addition, the District Court held that section 105 does not give a bankruptcy court the authority to ignore or otherwise expand upon the Bankruptcy Code by creating its own priorities. Furthermore, the District Court dismissed Kmart's argument that the decision would require it to commence hundreds of recovery lawsuits by stating that the bankruptcy court could simply order the vendors to return the money.

6. The District Court also did not consider the argument on appeal of the primary letter-of-credit issuer for Kmart's foreign suppliers, that the bankruptcy court had legal authority to issue the orders based on its ability to approve adequate protection for the letter of credit issuers under section 361 of the Bankruptcy Code. The argument was that since the letters of credit in that case were secured (consensually or by operation of law), the bankruptcy court could have approved payment to the critical vendors as a means of adequately protecting the letter of credit issuer (so draws could not be made by foreign suppliers on the letters of credit). Since this argument had not been raised at the bankruptcy-court level, the District Court would not consider it for the first time on appeal.

---

[17] The decision was redelivered on September 29, 2003, see 2003 U.S. Dist. Lexis 17437, probably due to the consolidation of an additional case.

7. Kmart appealed the district court's decision to the Seventh Circuit on April 10, 2003, where it is currently pending.

H. Implications Raised by the *Kmart* Decision

1. The reasoning underlying the *Kmart* decision raises serious concerns about the continued viability of the Doctrine of Necessity as it used in the context of critical vendor motions which could have significant and wide-ranging implications for debtors and creditors alike.[18]

2. Venue choices will likely be influenced because payments to critical vendors may no longer be an option in the Seventh Circuit. Also, there will be an underlying concern that courts in other circuits may follow the Seventh Circuit's example.[19]

3. While previously certain large creditors may have viewed their inclusion on a debtor's critical vendors list as an entitlement, and in certain instances the debtor may have been able to extract concessions and extensions of postpetition trade debt in exchange for including a creditor on a critical vendors list, as a result of the *Kmart* decision there may now be a shift in the balance of power in these "negotiations" as neither debtors nor creditors can be assured that such orders will be routinely granted. One aspect of this may be that a debtor may find it more difficult to obtain this relief even for the truly "critical" vendors (such as the blood supplier to a hospital and fuel supplier to an airline) where there really are very limited, if any, choices for substitution.[20]

4. Another potential consequence is that a debtor may seek to assume executory contracts under § 365(b) sooner in the case, as a prerequisite for the continuous provision of goods and services by vendors that it may otherwise have included on its critical vendors list.[21]

---

18 See Currie & McCann, supra note 2.

19 See id.

20 See Salerno, "The Mouse That Roared" Or, "Hell Hath No Fury Like a Critical Vendor Scorned", Last in Line, 2003 ABI JNL. LEXIS 114.

21 See First Day Motions and Orders in Large Chapter 11 Cases: (Critical Vendors, DIP Financing, and Cash Management Issues), 12 J. Bankr. L. & Prac. 59, 74 (2003).

IV. General Trends for First Day Orders

A. Financing Orders[22]

1. Chapter 11 debtor's sources of cash are often subject to prepetition security interests that provide that proceeds of those sources are also collateral. Under these circumstances, in order to use its cash collateral and/or to incur postpetition debt, the debtor must obtain a court order.

2. In an effort to secure their postpetition loans, lenders frequently request liens on avoidance actions of a debtor, including preference and fraudulent transfer actions.

3. Some courts, however, have held that avoidance actions belong only to the debtor or to the trustee and, therefore, cannot be given as security to a lender.[23] As a result, some financing orders now provide that the debtor grant a lien in the proceeds of the avoidance actions, as opposed to the avoidance actions themselves.[24] In addition, some financing orders provide that the lender must first look to the proceeds of other collateral before recovering from the proceeds of avoidance actions.[25]

4. Several recent cases have combined the debtor's strategy of selling its assets early in the case with its strategy for obtaining financing so that the proposed buyer also provided the necessary financing.[26] Such financing and sale orders have been entered notwithstanding objections that such an arrangement give the buyer an unfair advantage by forcing a rapid sale procedure under the threat of losing its financing.

B. Claims Trading[27]

1. Another recent trend is the increased frequency of motions filed at the onset of a case to limit the transfer of, and trading in, the debtor's claims and equity securities. These motions are often

---

[22] See Jay M. Goffman, First Day Motions and Orders in Large Chapter 11 Cases: (Critical Vendors, DIP Financing and Cash Management Issues), 12 J. Bankr. L. & Prac. 59 (2003).

[23] See Mellon Bank (east), N.A. v. Glick (*In re* Integrated Testing Products Corp.), 69 B.R. 901, (D. N.J. 1987); *In re* Tek-Aids Industries, Inc., 145 B.R. 253 (Bankr. N.D. Ill. 1992). Cf. Official Comm. of Unsecured Creditors of Cybergenics Corp. ex rel. Cybergenics Corp. v. Chinery, 330 F.3d 548 (3d Cir. 2003).

[24] See *In re* WorldCom, Inc., 296 B.R. 115 (Bankr. S.D.N.Y. 2003); *In re* Enron Corp., 300 B.R. 201 (Bankr. S.D.N.Y. 2003).

[25] See id.

[26] See *In re* Trans World Airlines, Inc., 2001 WL 1820325 (Bankr. D. Del. 2001); *In re* Peregrine Systems, Inc., Case No. 02-12740 (JKF) (Bankr. D. Del. 2002).

[27] See Goffman, supra note 22.

filed in order to protect a debtor's net operating losses ("NOLs"), which are often a valuable asset of a chapter 11 debtor's estate, as the Internal Revenue Code significantly limits a company's ability to carry forward NOLs in the case of an ownership change.[28] Such motions typically request a procedure requiring persons or entities that are, or become, substantial holders of either claims or equity interests of the debtor, to file and serve a notice of such status, and that such holders provide advance written notice of any intended transfer. The debtor would then have the opportunity to object to the transfer.

C. Retention of Financial Professionals

1. A chapter 11 debtor, especially in the larger cases, will often need to employ an investment banking firm to assist the debtor in selling one or more of its subsidiaries, affiliates, or divisions as operating businesses. In addition, the financial advisor may also assist a publicly held debtor in developing its plan of reorganization, and negotiating with committees of equity security holders, subordinated debenture holders, or unsecured bank committees. The official unsecured creditors' committees may also seek authority to employ their own financial advisors.[29]

2. While not a trend, it is of note that some bankruptcy courts have declined to approve the employment of financial advisors when the proposed terms materially deviate from the standards governing the employment of other professional persons. In particular, these courts have found as inconsistent with sections 327 and 328 of the Bankruptcy Code, proposed retention agreements that include indemnifications, substantial sign-on bonuses, flat monthly payments, and guaranteed success fees for financial advisors.[30] The fact that these same terms may be customary in the industry in nonbankruptcy settings was not persuasive with these courts. Some bankruptcy courts have approved the payment of flat monthly fees to financial advisors on a case-by-case basis while others have acknowledged the

---

[28] See IRC § 382(g).

[29] See 1-1 Collier Comp, Employ & Appoint of Trustees & Profs P 1.15 (2003).

[30] See *In re* Mortgage & Realty Trust, 123 B.R. 626 (Bankr. C.D. Cal. 1991); *In re* Hillsborough Holdings Corp., 125 B.R. 837 (Bankr. M.D. Fla. 1991); *In re* Drexel Burnham Lambert Group, 133 B.R. 13 (Bankr. S.D.N.Y. 1991); *In re* Gillett Holdings, Inc., 137 B.R. 452 (Bankr. D. Colo. 1991) ("[t]his Court does not here find that flat monthly payments were never permissible, or per se invalid, only that such payments have not been justified in this case."). See also *In re* Krug, 174 B.R. 826 (Bankr. D. Kan. 1994) (Professional Fee and Expense Guidelines appended).

authority of the court to impose a cap on monthly fees of financial advisors.[31]

3. Another recent development in the area of the retention of financial advisors is the frequency of requests by financial advisors for indemnification by the debtor. This is as a result of concerns raised by the case of *In re* Merry-Go-Round Enterprises, Inc.,[32] where a major accounting and consulting firm was sued by the chapter 7 trustee for causing the failure of the debtor as a result of the firm's negligence. U.S. Trustees have opposed such requests arguing that financial advisors should be held to a higher standard of care. In the recent case of United Artists Theatre Co. v. Walton,[33] the Third Circuit upheld the lower courts' decisions that such requests were reasonable.

458428

31 See *In re* Public Serv. Co., 160 B.R. 404 (Bankr. D. N.H. 1993); *In re* The Circle K Corp., 165 B.R. 653, 656-657 (Bankr. D. Ariz. 1994); *In re* Federal Mogul-Global, Inc., 348 F.3d 390 (3d Cir. 2003).

32 244 B.R. 327 (Bankr. D. Md. 2000).

33 315 F.3d 217 (3d Cir. 2003).